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Wise Money: How The Smart Money Invests

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Wildermuth WEALTH

WHITE PAPER

Using the Endowment Investment Approach to Make Better Investment Decisions

From the Author

Why write, or read, another book on investing? There are countless books on the market so hasn't enough been said on the subject already? Besides, what has been said hasn't appeared to be very helpful. Some investors believe the past few years highlighted the futility of investment planning and possibly even investing in general. The horrendous losses suffered by many in the 2008 global stock market crash seemingly confirmed the shortcomings of so many investment approaches.

The facts are ugly. The U.S. stock market declined nearly 40 percent in 2008 and dropped 55 percent from its high on October 9th, 2007 to its low on March 6th, 2009[1]. Possibly even worse for many investors, these declines were the second major market crash of the decade. The broad stock market indices produced negative returns over a ten-year period. Weak bond returns over the same period didn't help. The result? Too many investors earned zero or negative returns over an entire decade while enduring terrible volatility.

But this is only part of the investment story. While many individual investors struggled, college endowments generally enjoyed success over the same period. These organizations recognized years ago the many limitations of traditional investment approaches depending almost entirely on stocks and bonds. They developed and implemented a very different investment approach generally referred to as the "Endowment Model." This investment strategy seeks to increase return AND decrease volatility.

To be fair, no model, strategy or method of investing outperforms in every environment or circumstance, and the endowment model isn't an exception.

While even some institutions lagged in their adoption of the approach, today, some form of the endowment model nearly always anchors the investment strategy employed by college endowments, institutions and wealthy investors worldwide.

This brings me to my reason for writing this book. My experience and research has convinced me that smaller investors can replicate many of the same principles and practices successfully employed by institutions and wealthy investors. No individual investor will duplicate the exact performance of the endowments. Even different endowments don't earn the same results as one another. Yet I believe the basic principles and strategies can be transferred to much smaller portfolios providing individual investors attractive rewards. Hopefully, your belief that this may be true will provide you enough motivation to find out more.

Before jumping in, I'll supply a small warning. While none of this material is particularly challenging or revolutionary, applying the strategy may require an adjustment to your thinking. This strategy departs from the traditional, tired approach of using only U.S. stocks and bonds. It doesn't just tweak the existing logic; it completely discards major parts of it. This doesn't mean it's difficult to understand or implement. But it is a different approach. With that caveat, assuming you're still interested, I invite you to explore a new, and I believe much better, investment approach that may help you significantly better yourself financially, while also increasing your confidence and comfort with your finances.

The Need for a New Strategy

The years 2008 and 2009 treated the average investor very poorly. Stock market losses in 2008[1] were horrific at 37.0 percent for the Standard & Poor's 500 Index (S&P 500)[2] while the average equity sector mutual fund lost 39.70 percent.[3] The average American worker lost over one-quarter of his or her 401(k) retirement plan savings in 2008.[4] The beginning of 2009 continued the trend with the market declining more than 26 percent[5] before sharply reversing as general panic subsided. The market actually ended up 26.5 percent[6] in 2009.

The tremendous losses and volatility of these months and years left most investors not only frustrated but also often completely bewildered and overwhelmed. In addition, many supposedly safe investments suffered rough rides. In 2008, even investment-grade corporate bonds lost 5.3 percent.[7]

During this period of continuous tumult, I heard investors, journalists, and pundits echo similar sentiments that emphasized the horror of the situation and the futility of avoiding it. Others chose to dwell on the obvious challenges that only seemed to heighten the current panic. The overemphasis on near-term problems often resulted in recommendations to sell when challenges looked the worst and asset valuations were the lowest. The results were disastrous as far too many people, especially individual investors, unloaded their severely discounted investments at exactly the wrong time.

Of course, the drop in the markets brought out inevitable claims that we should have seen this coming and somehow timed the sale of investments. While this sounds wonderful, clairvoyance eludes nearly all of us. How do we know ahead of time that corporations will lose money, banks will stop lending, or people will panic?

This simple answer seems to be that we can't, and we don't. I don't believe this situation will change. Moreover, the same reality apparently applies to even the world's most sophisticated and resourced investors. During this downfall, much of the downward pressure on the markets resulted from professionals unloading their holdings. The world's largest banks and hedge funds often sold at huge losses at the worst possible time to deleverage their balance sheets. They needed cash at all costs just when cash was most expensive.

If the experts and investment insiders couldn't get it right and in this downturn often contributed to the meltdown, how can individual investors avoid disasters? Unfortunately, I believe it's nearly impossible unless you completely avoid any type of investment vehicle. Over a longer time frame, the loss of purchasing power resulting from lack of return can pose a greater risk to nearly any investor than potential investment losses. As a result, most people must assume some type of risk in order to generate real investment returns.

Yet when pondering investments in stocks, the question isn't *will* the stock market crash or *will* we have another crisis. It's a matter of *when*. The economy will almost certainly experience major challenges in the future and new technology developments will disrupt established industries or even national economies. In fact, the accelerating pace of change in seemingly every area of life suggests more frequent crises and challenges. The stability of 20, 30, or even 50 years is probably just a memory rather than a likely future. The introduction of the microchip into our daily lives likely ensures that nearly everything will permanently move at a faster and faster pace, including economic ups and downs.

So, if I'm saying that you can't avoid or foresee problems well enough to completely avoid them, and avoiding risk isn't really a viable strategy, what options are there? Given this environment and the likely unpredictable volatility of global markets in the future, what can investors do?

Very simply, I believe more consistent and predictable success requires a different investment approach. The strategy utilized must be capable of weathering inevitable storms regardless of size and duration. The approach must provide the performance and stability most investors need while also satisfying income and liquidity requirements. Of course, this sounds wonderful, but is it possible?

I believe the answer is yes. The strategy I'm referring to has been developed and successfully employed by many of the world's wealthiest and most successful university endowments as well as institutions and private wealth managers across the globe. Endowments and institutions, with very large amounts of money at stake and very substantial intellectual capital, believed there was a better way to excel in a rapidly changing world. They developed an approach often referred to as the "endowment strategy," which deviates significantly from the traditional stock and bond models of yesteryear. The strategy isn't new; it's just not familiar to most individual investors.

Sophisticated endowments recognized that changes in the global economy and investment landscape provide new opportunities to increase returns while also lowering portfolio volatility. Moreover, these same institutions determined that success requires breaking from dated models and strategies developed for a dramatically different world and historical context.

Their performance illustrates their success. The average U.S. investor with a 60 percent stock and 40 percent bond portfolio earned exactly 0.00 percent for the 10-year period starting January 1, 2000, assuming modest fees of 2.0 percent for stocks and 0.5 percent for bonds.[8] Unfortunately, most studies reveal that the average individual didn't do nearly this well, as the performance of most investors dramatically trail that of broad market indexes. By contrast, Yale, Harvard, and Stanford's endowments enjoyed a solid run over the same time period with returns across the three averaging just under 10 percent per year, including all fees.[9]

You may be thinking that this strategy must be too complex or difficult for the average investor to adopt. Or, your lack of billions must prevent you from accessing the investments that have enabled the endowments to achieve their success. Not only do I believe the average investor can successfully employ this strategy, various other experts do too.

A broad study by the *Journal of Wealth Management* highlights investor possibilities. Very simply, the journal claims that investment returns earned by endowments resulted primarily from strategies replicable by individual investors. More specifically, after a very thorough review of Yale's performance during the 20-year period ending in fiscal year 2007,[10] the *Journal of Wealth Management* concluded that even Yale's endowment management showed little skill or luck in selecting managers outside of the category of private equity. Their review of the 10-year data supported the same conclusion.

The source of the Yale endowment's success is critical. It results from the asset classes the institution invests in rather than the superior management of the funds within the asset class. With the exception of private equity for Yale, success derives from original investment choices, not contacts, managers, or skills out of the reach of any individual investor.

This conclusion bears repeating. Success results from strategy, not exceptional skills, access, or experience. The implications to individual investors are tremendous because individuals can copy strategy, and the rapid expansion of investments has provided individuals access to similar types of investments used by endowments.

This conclusion is exciting and encouraging. Of course, we have to be careful here. Obviously, this study doesn't claim that everyone will enjoy similar success, and they add the caveat that Yale's private equity success has been an exception because its returns have been phenomenal. Furthermore, there are considerable differences in investment success experienced by endowments themselves, and individuals will almost certainly see similarly varying results. For instance, other institutions following the endowment model have achieved excellent success without duplicating Yale's private equity performance.

The report also mentions that a major part of these endowments' success is "consistent exposure to diversified, risk-tilted, equity oriented assets."[11]

I'll jump in here with some editorial comments. *Easy* by their definition means something different than most of us understand in common conversation. *Easy* indicates that investors willing to put the effort into understanding and planning can create a similar strategy. In other words, the strategy is not beyond the reach of individual investors. Developing a vastly improved approach, however, isn't the same as pushing the big red Easy button. Some effort is required.

Regardless, the conclusion that the model can be emulated via widely available strategies remains very notable. While I've referenced this study specifically, there's tremendous additional research that decisively supports the same conclusion, and so do the results of my own professional experience. Anyone can do it!

In fact, domestic stocks and bonds often comprise less than a quarter of an endowment's portfolio versus all, or nearly all, of the typical investor's. Instead, endowments diversify their portfolios through adding multiple investments with strong performance potential that are expected to perform more independently of one another. Their investments can include foreign developed market stocks, emerging market stocks, institutional quality real estate, commodities, private equity, hedge funds, managed futures, and debt-driven instruments. I realize that the list can appear daunting, especially if you haven't heard of many of these investments, but don't let the labels intimidate you. A decade ago, high-quality versions of many of these investments were difficult or impossible for individuals to access; today, excellent choices are readily available to individual investors.

As did individual investors, endowments held U.S. stocks during the first decade of the millennium, and their domestic stock holdings usually suffered like those held by individuals. Yet, unlike far too many individual investors, endowments enjoyed success over the previous decade because other assets in their portfolios performed well while stocks languished.

This practice makes sense if a portfolio holds only one other volatile and unpredictable asset: domestic stocks. In contrast, endowments seek to lower volatility through broadly diversifying their performance assets rather than simply reducing these holdings.

Like many individual investors, endowments also depend on their portfolios to satisfy present-day financial needs. If required, a good portfolio design should consistently and predictably supply necessary income. The most obvious means to generate funds is through inclusion of investments that produce income directly. But for many individual investors, and for nearly all endowments, yields from income-producing investments aren't high enough to cover total funding needs, and additional income must be generated through sale of some holdings. When asset sales augment total portfolio income, it's imperative that assets are available that can be easily converted to cash with no, or very little, risk of loss.

While endowments have used multiple assets to deliver portfolio income for years, some individual investors are just waking up to the simple fact that bond yields are probably not high enough to provide sufficient portfolio income no matter how much of the portfolio they make up. As a result, income needs greater than a percent or two of total portfolio assets require that a portfolio be constructed to enable predictable and profitable sales of assets. The multiple assets within an endowment's portfolio offer a high probability that income needs can be advantageously met via the sale of an appreciated investment. In the rare but possible case that every performance-oriented asset in an endowment's portfolio declines, minimal holdings of safer and highly non-correlated assets, such as bonds, provide a safety value that can cover immediate funding requirements. A good portfolio design satisfies current income needs *and* offers much higher long-term performance potential than is possible with a simple domestic stock and bond approach.

The rest of this book looks at various ways that this strategy can be applied and adapted to individual investors' specific situations. All of us are unique, and we all have different financial and emotional desires and needs. The financial landscape constantly changes, which presents evolving opportunities and challenges. Successful application of the endowment model requires your molding this strategy to your particular needs.

(Endnotes)

i. Market closing value peak on October 9, 2007 was 1565.15. Market closing value bottom was on March 9, 2009 at 676.53. Percentage loss of 55.38 percent does not include dividends.

1. For the sake of simplicity, references to any investor refers only to investors located in the United States. While the principles discussed work very well in any country, specific facts referenced will differ depending on your country of domicile.
2. Standard & Poor's, S&P 500 Equity Indices Fact Sheet, December 31, 2008.
3. Rob Wherry, "Our Mutual Fund Report Card for 2008," January 7, 2009, http://www.smartmoney.com/invest/funds/Mutual-Fund-Report-Card-for-2008/.
4. Tiburon Research, Key Driving Factors: Defining the Role of Consumer Wealth, the Institutional Markets, and Current Events in the Future of Advice, March 2010, p. 9, http://www.triburonadvisors.com.
5. On March 6, 2009, the S&P 500 fell to an intraday low of 666.79. The RIC Report, Investment Strategy, Bank of America Merrill Lynch, March 11, 2011, p. 1.
6. Standard & Poor's, S&P 500 Equity Indices Fact Sheet, December 31, 2009.
7. Barclays Capital, 2009 Barclays Capital Equity Gilt Study. Also The Investor, "Historical Returns from Corporate Bonds, "Monevator.com, August 26, 2009, http://monevator.com/2009/08/26/historical-returns-corporate-bonds.
8. Harvard University Financial Report, Fiscal Year 2009, p. 10, via S&P500/Citigroup US BIG.
9. The Yale Endowment, reports for years 2000 to 2009; Harvard University Financial Report 2009, p. 10. Also report from the Stanford Management Company, 2009, p. 2.
10. Peter Mladina and Jeffrey Coyle, "Yale Endowment Returns: Manager Returns or Risk Exposure?," Journal of Wealth Management, Summer 2010, p. 47.
11. Mladina and Coyle, "Yale Endowment Returns," p. 48.

IMPORTANT DISCLOSURE

Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund. This and other important information is contained within the Fund's Prospectus, which can be obtained by calling (888) 889-8981, or by visiting our website www.wildermuthendowmentfund.com . The Fund's Prospectus should be read carefully before investing.

The Fund is a closed-end interval fund. Investing in the Fund involves risk, including those summarized below. An investment in the Fund is generally subject to market risk, including the loss of the entire principal amount invested. An investment in the Fund represents an indirect investment in the securities owned by the Fund.

You should consider the shares to be an illiquid investment. Even though the Fund will make periodic repurchase offers to repurchase a portion of the shares to provide some liquidity to shareholders, only a limited number of shares will be eligible for repurchase by us. Once each quarter, the Fund will offer to repurchase at net asset value (NAV) per share no less than 5% of the outstanding shares of the Fund, unless such offer is suspended or postponed in accordance with regulatory requirements. The Fund may increase the size of these offerings up to a maximum of 25% of the Fund's outstanding shares, in the sole discretion of the Board, but it is not expected that the Board will do so.

You should consider that you may not have immediate access to the money you invest for an indefinite period of time. An investment in our shares is not suitable for you if you need immediate access to the money you invest.

Endowments have a long term investment time horizon with low liquidity needs. Investors should consider how closely their investment goals and needs match those of endowments.

Certain investments in the Fund are illiquid making it difficult to sell these securities and possibly requiring the Fund to sell at an unfavorable time or price. The value of certain Fund investments, in particular non-traded investment vehicles, will be difficult to determine and the valuations provided will likely vary from the amounts the Fund would receive upon sale or disposition of its investments.

Like all financial instruments, the value of these securities may move up or down, sometimes rapidly and unpredictably. The value of your investment in the Fund at any point in time may be worth less than the value of your original investment, even after taking into account any reinvestment of dividends and distributions.

When the Fund invests in equity securities, the Fund's investments in those securities are subject to price fluctuations based on a number of reasons of issuer-specific and broader economic or international considerations. They may also decline due to factors which affect a particular industry or industries. In addition, equity securities prices may be particularly sensitive to rising interest rates, as the cost of capital rises and borrowing costs increase.

The Fund may invest in publicly-traded and non-traded REITs or privately offered pooled investment vehicles that hold real estate as well as invest in real estate directly through entities owned or controlled directly or indirectly by the Fund. As a result, the Fund's portfolio may be significantly impacted by the performance of the real estate market and may experience more volatility and be exposed to greater risk than a more diversified portfolio.

REIT share prices may decline because of adverse developments affecting the real estate industry and real property values. In general, real estate values can be affected by a variety of factors, including supply and demand for properties, the economic health of the country or of different regions, and the strength of specific industries that rent properties.

Exposure to the commodities markets may subject the Fund to greater volatility than investments in more traditional securities. The value of commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as weather, and international economic, political and regulatory developments.

The Fund may invest in medium- and small-capitalization companies, which may be newly formed or have limited product lines, distribution channels and financial or managerial resources. The risks associated with these investments are generally greater than those associated with investments in the securities of larger, more-established companies. This may cause the Fund's net asset value to be more volatile when compared to investment companies that focus only on large-capitalization companies.

The Fund is classified as a non-diversified management investment company under the Investment Company Act of 1940, as amended. This means that the Fund may invest a greater portion of its assets in a limited number of issuers than would be the case if the Fund were classified as a diversified management investment company. Accordingly, the Fund may be more sensitive to any single economic, business, political or regulatory occurrence than the value of shares of a diversified investment company.

The shares have no history of public trading, nor is it intended that the shares will be listed on a public exchange at this time.

We do not expect a secondary market in the shares to develop. Even if any such market were to develop, closed-end fund shares trade frequently at a discount from net asset value, which creates a risk of loss for investors purchasing shares in the initial public offering.

Wildermuth Endowment Fund's principal underwriters and co-distributors are Wildermuth Securities, LLC and UMB Distribution Services, LLC.